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State aid in Croatia: things are still moving forward

Marina Kesner-Škreb, MSc

The percentage of GDP allocated for state aid in Croatia is five times the EU average. However, figures on subsidies in the adopted state budget for 2009 suggest a desire for some positive movements. In this paper we present the main highlights of the most recent Annual Report on State Aid for 2007 by the Croatian Competition Agency¹, and from the adopted State Budget for 2009².

In 2006 and 2007, total state assistance to the economy shot up in Croatia. State aid rose by almost HRK 4 million or 77% in 2007 compared with that in 2005. The sharpest increase (to a double amount) was recorded in aid to manufacturing and services sectors. However, aid to agriculture was also not negligible, so that the amount allocated for agriculture went up 50% in 2007 relative to 2005. The share of state aid in GDP also increased, from 2.2% to 3.3%, and state aid per person employed stood at HRK 6,000 in 2007, over two thirds more than two years before.

Table 1 Total state aid in Croatia, 2005-2007

	million HRK			Annual rate of change (%)		
	2005	2006	2007	2006/ 2005	2007/ 2006	2007/ 2005
Agriculture and fisheries	2,124.7	2,535.5	3,210.2	19.3	26.6	51.1
Manufacturing and services	2,932.7	5,374.4	5,737.2	83.3	6.8	95.6
TOTAL	5,057.4	7,909.9	8,947.4	56.4	13.1	76.9
Total state aid as a share of GDP (%)	2.2	3.2	3.3			
Total aid per person employed (HRK)	3,560.1	5,388.6	5,898.5			

Source: Author's calculation based on the CCA's Annual Report.

The growth in state aid was particularly strong in 2006, due to the rescue and restructuring of shipyards, and aid granted to Croatian Railways. In September 2006, within the so-called "shipyard rescue package", an amount of HRK 4.2 billion was granted in the form of state

¹ At its session on December 5, 2008, the Croatian Parliament adopted the Annual Report on State Aid for 2007, delivered by the Croatian Competition Agency (CCA) which is responsible for granting, supervision and repayment of state aid. The Report is available at: http://www.aztn.hr/pdf/izvjesca/godisnje_izvjesce_DP_2007.pdf.

² The State Budget for 2009 was adopted by the Parliament on December 15, 2008 and is available at: <http://www.sabor.hr/Default.aspx?art=25631>.

guarantees, of which HRK 1.55 billion was activated by end-2006, and HRK 1.7 billion during 2007. Another cause of total state aid growth was a change in legislation aimed at the **liberalization of railway transport** that entered into force on 1 January 2006³. After this point, the monopolistic market status of the Croatian Railways was abolished and state funds granted to this sector began to be considered as state aid, which was previously not the case. As a result, state aid to the Croatian Railways grew from a zero amount in 2005 to HRK 822 million in 2006 and HRK 906 million in 2007.

What is state aid?⁴	
According to an EU definition, state aid is any aid which:	
1 is granted through state resources;	
2 confers an economic advantage on an undertaking, sector or region;	
3 is selective as it disturbs the balance between undertakings and their competitors; and	
4 affects competition and trade between Member States.	
State aid can be divided into horizontal aid (designed for all undertakings within an economy), sectoral aid (targeted on selected undertakings), regional aid and aid to agriculture and fisheries. Aid can be granted through a variety of instruments: subsidies, tax relief, equity participation, soft loans, tax deferrals, guarantees, etc.	

The structure of state aid deteriorated during the three observed years, in so far as the share of horizontal aid in total aid halved. Horizontal aid is intended for all undertakings and sectors, and it distorts market competition to a much smaller extent than sectoral aid which is granted to a particular undertaking or sector. The European Union is strongly in favour of horizontal aid and the phrase "less but better aid", often used in key EU documents, is just aimed at stimulating the Member States to develop the horizontal aid. Consequently, Croatia should endeavour to reverse the horizontal aid trend, in order that the government may stimulate investment in R&D, environmental protection, SMEs, and the like.

Table 2 State aid by sector (excluding agriculture)

	2005-07	2005	2006	2007	2005-07
	million HRK	%			
Manufacturing and services	14,044.4	100.0	100.0	100.0	100.0
Horizontal objectives	2,585.6	28.4	17.3	14.3	18.4
Research and development	429.0	4.4	2.6	2.8	3.1
Environmental protection and energy conservation	51.6	0.2	0.4	0.4	0.4
Small and medium-sized enterprises	327.9	1.5	4.5	0.7	2.3
Training	359.0	2.6	1.9	3.2	2.6
Employment	962.3	9.1	6.2	6.3	6.9
Culture	220.7	2.6	1.7	1.0	1.6
Other objectives	235.0	8.0	0.0	0.0	1.7
Selected sectors	10,084.1	61.9	75.0	73.9	71.8
Steel manufacture	213.8	0.6	0.0	3.4	1.5
Transport	3,216.7	14.2	25.9	24.5	22.9
Shipbuilding	5,148.1	21.9	40.9	40.2	36.7
Tourism	621.4	6.2	4.9	3.1	4.4
Other sectors	262.8	1.9	3.1	0.7	1.9
Rescue and restructuring	621.2	17.1	0.2	1.9	4.4
Regional aid	912.2	5.1	5.3	8.4	6.5
Local aid	462.5	4.6	2.5	3.4	3.3

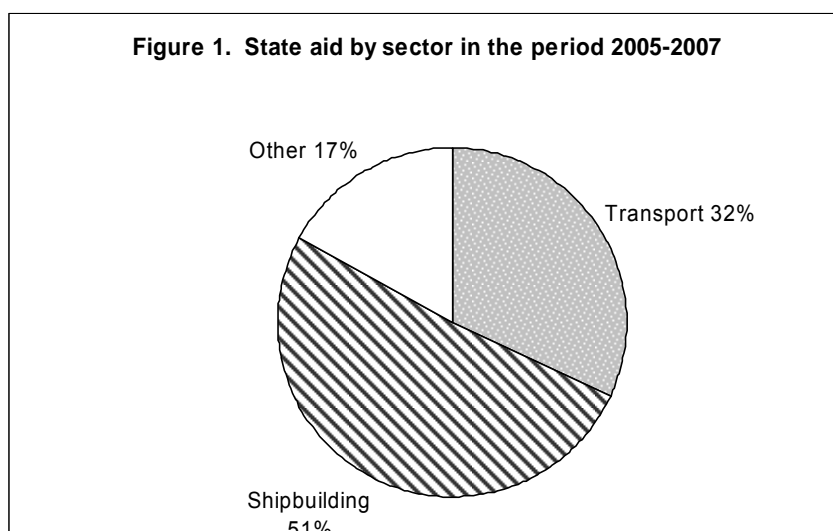
Source: Author's calculation based on the CCA's Annual Report.

³ The Railway Act (OG 123/03 and 30/04) and the Act on the Dissociation of the Company HŽ – Hrvatske željeznice d.o.o. (OG 153/05).

⁴ For a more detailed definition, see the CCA's Report at: http://www.aztn.hr/pdf/izvjesca/godisnje_izvjesce_DP_2007.pdf.

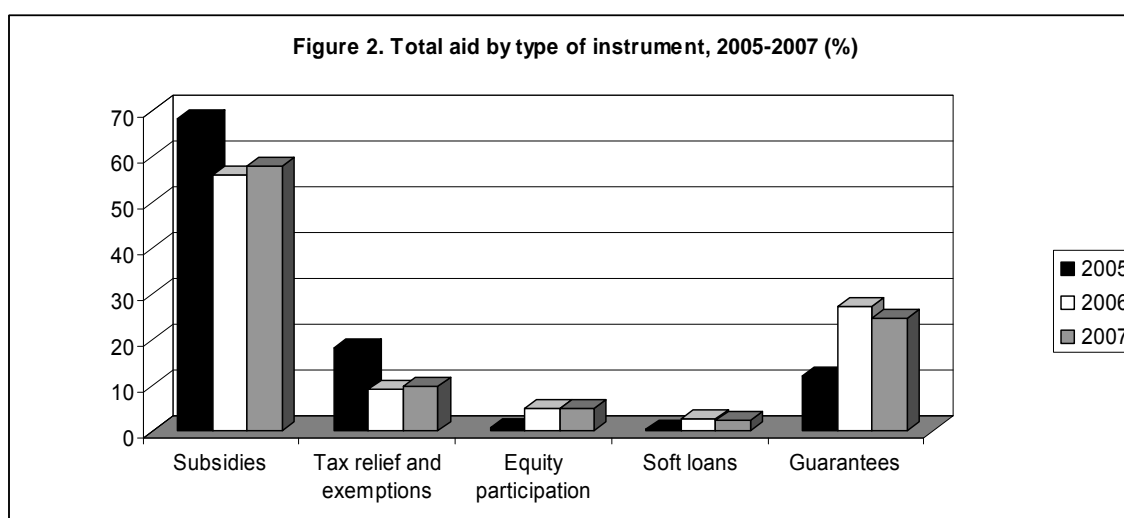
Along with a decline in horizontal aid, the share of **aid provided to selected sectors rose** by 12 points, i.e., the share of sectoral aid increased from 62% of total aid (excluding agriculture) in 2005 to 74% in 2007. The growth in sectoral aid was a direct consequence of the strengthening of aid to transport and shipbuilding. Of the total sectoral aid of HRK 10 billion, granted in the period 2005-2007, these two sectors accounted for as much as HRK 8.3 billion. Transport and shipbuilding thus accounted for 83% of total aid, whereas as little as the remaining 17% went to all other economic sectors.

Continuous increase was observed in regional aid aimed at stimulating economic growth of less developed regions and granted mainly in the form of tax relief. Together with aid granted at the local level, it accounted for 9% of total aid in the period 2005-2007.



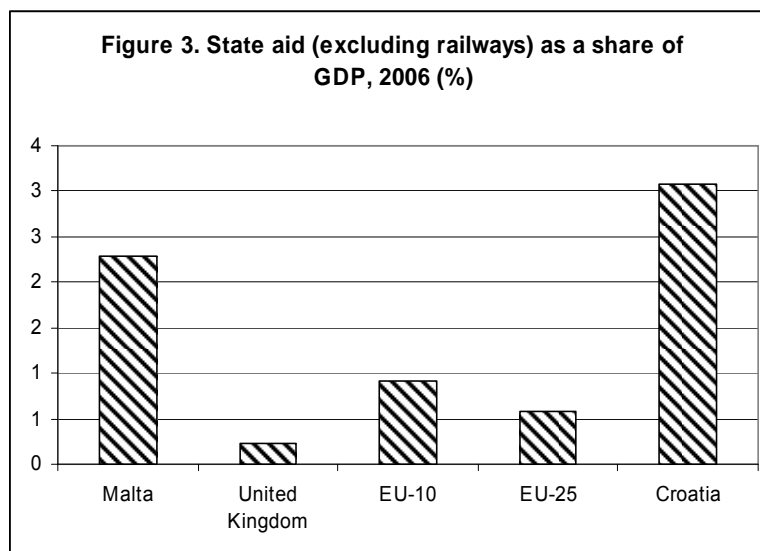
Source: Author's calculation based on the CCA's Annual Report.

In Croatia, economic assistance is generally provided in **the form of subsidies and government guarantees** (58% and 25% respectively in 2007). The utilisation of subsidies prevails in the agriculture and fisheries sector, whereas sectoral state aid is most frequently in the form of government guarantees and is mostly provided to the shipbuilding sector. The third position belongs to tax relief and exemptions, whereas equity participation and soft loans are the least used.



Source: Author's calculation based on the CCA's Annual Report.

Within the EU, Malta spends the largest amount on state aid, 2.3% of its GDP, and the United Kingdom as little as 0.2% of GDP⁵. The entire EU average is 0.6%, and the average for new Member States stands at 0.9% of GDP. With 3.1% of GDP allocated for state aid, Croatia exceeds all the mentioned shares, **and the amount allocated for state aid is five times the EU average.**



Source: Author's calculation based on the CCA's Annual Report.

However, the recently adopted State Budget for 2009 suggests some positive movements in subsidies, being the main state aid instruments. Specifically, following their strong growth in 2007 and 2008, by 14.5% and 13.8% respectively, subsidies granted from the state budget **are expected to fall** over the next year, by 6.7% or about HRK 500 million. Encouraging is a decline in subsidies to large state aid beneficiaries: shipyards and the Croatian Railways. According to projections for 2010 and 2011, subsidies should maintain roughly the same level as in 2009. It will soon be shown whether such changes indicate a trend reversal, or the government will resume the subsidizing of chronic loss-makers in Croatia. Changes to be introduced within Croatia's accession to the EU will provide a strong external impetus to abandon the policy of subsidizing the current operations of long-standing loss-makers and to redirect aid to essential and urgent structural reforms.

Table 3 Subsidies in the 2009 State Budget

	Outturns 2007	Budget for 2008	Proposal for 2009	Projection for 2010	Projection for 2011
BUDGET EXPENDITURE (million HRK)	108,007	117,262	123,396	131,800	138,470
SUBSIDIES (million HRK)	6,492	7,391	6,895	6,934	6,836
Annual rate of change (%)	14.5	13.8	-6.7	0.6	-1.4
Share of subsidies in total budget expenditure (%)	6.0	6.3	5.6	5.3	4.9

Source: Author's calculation based on the State Budget for 2009.

⁵ Compared here is state aid excluding railways, as normally presented in the EU.